Minutes of the Fifth Meeting of the Working Group on Distributions of Securitized Products

1. Date
May 27, 2008 (Tuesday) 15:00 to 17:00

2. Place
JSDA Conference Room

3. Participants
As stated in Appendix 1

4. Agenda
(1) Establishing procedures for collecting and reporting on details and risks of underlying assets (Continued from previous meeting)
(2) Internal procedures for evaluating, calculating, and reporting theoretical prices

5. Summary of Proceedings

At the start of the meeting, the WG Chair made the following comments.
(Today's agenda)
- Today we will be concentrating mainly on discussions. We will discuss about the comments we received, mainly from WG members, regarding the document on s establishing procedures that was prepared and submitted by the WG Chair and deputy Chairs during the previous meeting. In addition, we also want to discuss about setting up internal procedures related to theoretical prices.

(The WG's schedule)
- At the sixth meeting to be held on June 5, the Unified Information Disclosure Format Initiative Team will present a report on the results of their discussions from the point of view of "what information disclosure items are necessary to enable investors to make their own risk assessment." We also want to deepen the discussions on establishing procedures that are being held today. At the previous meeting, it was commented that it would be difficult to discuss establishing procedures when the details of the unified information disclosure format were not yet on the table. To deal with that problem, we are going to discuss the issues at this and the next meeting, and if necessary at yet another meeting.
- In July's interim report, we will summarize the points regarding "what type of information disclosure items would be appropriate" and "methods of establishing procedures to ensure the provision of such information" under the headings of "Views" and "Issues."

Continuing, the WG Chair mentioned the following reference to the securitization market made in the second report of the Council on Economic and Fiscal Policy's Expert Committee on Reforms Addressing Globalization " Toward Reform of Public Pension Fund Management"- Capitalizing on Global Economic Growth to Enhance People's Affluence - (May 23, 2008)) that was related to the WG's discussions.

*3. Sound Development of Securitization Products Market*

*Securitization products in general have been under the intense, critical scrutiny of the public since the occurrence of the subprime mortgage loan problem in the United States, as the problem involves financial products developed on the basis of securitization of mortgage loans provided to people with relatively low levels of creditworthiness. However, we should not allow the problem to deter us from taking advantage of securitized products but learn lessons from that, carry out reform and soundly develop the market for such products.*
*Securitization contributes to broadening means of fund-raising, efficiently diversifying risks, increasing the diversity of the portfolio and reducing trading costs. Securitization thus enhances the credit creation capability of the financial and capital markets and serves as an important tool for strengthening the competitiveness of the Japanese markets.*
*In order to soundly develop the market for securitization products, it is necessary to enhance and improve information disclosure and risk management by financial institutions, regulation and supervision by the authorities including monitoring, and credit rating methods used by the credit rating agencies. In this respect, the Financial Services Agency and other relevant organizations should be actively involved in discussions at international organizations such as the International Organization of Securities Commissions (IOSCO) and the Financial Stability Forum (FSF), and quickly proceed with an examination on the establishment of necessary institutional frameworks.*

(Item 1) Establishing procedures for collecting and reporting on details and risks of underlying assets (Continued from previous meeting)

A WG deputy Chair gave his impressions of the opinions they received from different companies on the documents in appendices 8 and 11 of the previous meeting.
- Roughly speaking, there were three points of discussion regarding internal procedures set-up, 1) views on which information should be collected and provided before selling, 2) establishing an internal procedures to provide information at time of sale, and 3) what to do about provision procedures after distributions. He recognized that all companies were already being responsible in all of these areas, but had the impression that there was no prevailing opinion on how these three points should be determined in the discussion of establishing procedures.
- For Appendix 8 of the previous meeting, opinions were roughly divided into the two points of 1) views on information items, such as how to consider the content of information and 2) views on internal procedures, staff, and organizations. In addition, opinions regarding 1) were divided into (1) standards for judging whether information was necessary or not, as well as available or not (hereinafter referred to as “judgment standards”) and (2) the process of recording information (hereinafter referred to as “recording information”). At any rate, most of the opinions offered by companies were regarding 1) (Standards for judging whether information was necessary or not, as well as available or not).

Continuing on, the WG deputy Chair introduced the major opinions submitted by different companies, as described below. The examples were compiled beforehand and supplemented appropriately with points that had already been determined by the WG.
(Opinions regarding the unified information disclosure format)

- As stated previously by the WG Chair, there is an opinion stating that discussions cannot proceed before the details of the unified information disclosure format are determined. This is a valid point and how to express it in the interim report and other documents will be discussed in the next meeting (We believe that how the unified information disclosure format should be treated in the interim report will become clear during the discussions in the next meeting). Moreover, from fall onwards, a wide range of stakeholders will be participating in the discussions, and we plan to brush up our unified information disclosure format at that time to ensure a minimum standard.
- The discussion on the unified information disclosure format should not be about what kind of checklist format to use, but to take into consideration the intention and spirit of the underlying the supervision guidelines in discussing internal procedures to ensure its effectiveness. Focusing discussion on the structure of the unified information disclosure format as a manual or check list will lead to a loss of substance. Instead the discussion should focus on what "recording information" means and what sort of practical systems are needed to ensure "judgment standards."
- In contrast to the above opinion, there was also the opinion that a check list feature should be expanded little more and more items should be added regarding risk judgment in order to make the unified information disclosure format as close to a manual as possible. This process will reduce the burden placed on companies that are only selling the products and were not involved in their origination.
- The burden placed on each relevant party should be taken into consideration in determining the items in the unified information disclosure format. We believe this is very important in terms of maintaining a balance between ensuring the provision of information and achieving market efficiency.

(Opinions regarding the scope of products to be covered)

- The scope of the securitized products to be covered by the procedures being established should be clearly laid out. Regarding this point, as can be seen in Appendix 4-(3), although there are a few exceptions, almost all securitized products fall under the supervision guidelines. Therefore, provision procedures are necessary for the inspection process before distributions, point-of-sale, and following sale. Within that process, since a basic consensus among involved parties concerning the details of the information to be provided for the securitized products falling within the scope of oversight has been reached, we consider that it is appropriate to create a unified information disclosure format as a representative case on which to base our investigations. As we see it, this is an idea that was chosen among other ideas about how to reduce the burden on related parties.

(Regarding secondary transactions)

- There should be rules for excluding products that already have robust secondary markets in order to reduce the burden on related parties.

(Difficulty of complying on a practical level)

- Several opinions were expressed regarding the possibility of the procedure being difficult to comply with on a practical level. The opinions were divided into how to deal with the "judgment standard" and whether "recording information" was really necessary. Regarding "judgment standard," it was thought that if the standards were not made a little clearer, there would be no increase in the predictability of regulations or supervision. From this point of view, perhaps the standards should include moral and format standards. Concerning "recording information," there are

opinions stating that considering the frequency and type of transactions, it may be impossible in practical terms.
- Recording information, such as writing reasons—in other words whether the unified information format is input or not input—should not be an issue and, the facts should be made public as is. By doing that, they will be reflected in market price, which will then lead to greater transparency in the market.
- Recording information "adequately" will be difficult.
- There are issues and opinions regarding how to actually ensure that distributors have the ability to trace assets after the sale of the product. Given that the supervision guidelines consider that the investor and not the distributor is the party concerned with traceability, we felt that this is a significant opinion.

(Opinions regarding details and scope of information to be provided)
- Opinions were expressed on whether or not the distributor should divulge opinions and ideas resulting from its own analysis to the investor.
- Is it really necessary to provide the actual analysis of the details and risks of underlying assets?
- The nature and purpose of the information requested by investors that must be provided should be clarified.
- Simply having an "information item" is too lax a standard, and greater clarification is necessary to increase the predictability of regulations and oversight.
- Not all items disclosed at the point-of-distributionshould have to be traceable following sale.
- Obligations to explain and comply with other laws and regulations should be clarified.
- Considering the situation where during the selling process distributors collect and provide information on individually required items, as a "judgment standard" the distributors should have to not only think about these items before listening to the opinion of investors, they should also provide information requested by investors. Conversely, information that investors say they don't need should not be required to be provided.

(Opinions on information provided on liquidity risk)
- The supervision guidelines mention liquidity risk, however, this requires the provision of information on risk other than that of the underlying assets and to my mind does not mean requiring information specifically about liquidity risk. In Appendix 8, however there is a section specifically on liquidity risk, and I wonder if this is not a mistake.

(Opinions on human resources and organizations)
- As indicated in the responses to the FSA's public comment paper, the FSA is not going to require a uniform internal procedure, so we should reflect that in reports in an appropriate manner.

(Opinions on counterparties in disclosing information)
- Whether or not distributors were expected to make their data public was asked. As was explained before by the Secretariat, we are not expecting to make the data public; we are looking at the provision of information by those selling or intending to sell. In the responses to the FSA's public comment paper, it is indicated that the supervision guidelines do not cover cases where the investor can access information, but the cases where the investor cannot. Generally speaking, when an investor cannot get accessed to publicly announced information, the distributor has a greater burden of responsibility. Conversely when the information is publicly available, the distributor has a lower degree of responsibility. In Appendix 8 of the

previous meeting, as we understand it, this meaning is included in the words “third party” or “independent.”

- A question regarding the responsibility in cases where incorrect data is provided by a distributor was asked. As is stated in the responses to the FSA’s public comment paper, “where the investor has not made a risk assessment, the distributor should not be liable for damages.” Whether or not we discuss liability issues in a WG of the JSDA, our results would not be applicable under civil law, and therefore we believe that this issue is not within the scope of JSDA regulations.
- An opinion was expressed that at this time it would be difficult to determine investors who are holding securitized products. On this point there is room for debate on whether this should be handled within self-regulatory rules or whether in-house rules at individual firms would be sufficient.

The WG Chair commented that one of the major purposes of the WG was to foster this sound development of the securitized product market in Japan. To that end, it was essential not to establish a system that would protect the interests of securities companies with a strong record in underwriting. It was important to make it a system that would attract the entrance of new securities companies and new investors.

The following comments were made by WG members.

- After the creation of a securitized product, when a distributor that is not the originator reassesses the product and manages risks, it takes a lot of work to expand distributions. This is mainly caused by the fact that the distributor does not have direct access to the underlying assets. In that sense, I think it would be the same when an investor conducts his/her evaluation. If information disclosure is standardized and improved at the origination stage and disclosure continues forward it will be possible for a non-originating distributor to effectively carry out evaluations and risk management. In addition, it will likely facilitate investment in securitized products by investors. We believe that it is necessary to make highly transparent securitized products and increase the number of investors, thereby broadening the market and increasing liquidity. For that purpose, the WG’s strategy is to make a unified information disclosure format and even information vendors are planning on increasing their functions. What is important is that we standardize information and put it in a uniform information disclosure format, in order to set the stage for participation of a wide-range of market participants.
- The WG is making progress on discussions about the securitized products to be covered by the unified information disclosure format, and in this sense I am relieved. On the other hand, I don’t think there has been any conclusive debate on whether to include or exclude securitized products not covered by the unified information disclosure format from the scope of the WG’s discussions (= object of the supervision guidelines). For example, in terms of funds, there are a myriad of investment forms: real estate beneficiary interests, pools of real estate beneficiary interests, investment partnerships, overseas investment associations, and mutual funds. Although in form they may be similar, I can’t see any way in which they could be ordered because they are covered by different sections of Financial Instruments and Exchange Act, such as Paragraph 1 and Paragraph 2 securities. Although at this point the scale of these securitized products is not that large, we have to be serious about developing this market. If we leave this unclear portion as it is, there is the danger that it could cause turmoil in the future in terms of our

procedures and organizations and various other aspects. I think we need to reduce the number of products that are not covered by the unified information disclosure format.

- What should be done about the gray areas in Appendix 4-(3)? It should be made clear whether we are going to be consistent in the way we deal with the gray areas as much as possible or whether we are going to leave it up to individual companies to deal with the gray areas in their own way.
- The information items listed in the unified information disclosure format covers to a great degree the information necessary for investors to make their risk assessment, however, it is not sufficient. In other words, among the information necessary for investors to know on the details of underlying assets or to make risk assessments, there are great many items which have not been included, such as macro economics information and loan conditions in the housing loan market. Thinking about the background to the supervision guidelines, the Plan for Strengthening the Competitiveness of Japan's Financial and Capital Markets unveiled by the FSA in last December indicated that it was essential to improve traceability of the underlying assets of securitized products. Furthermore, if we look at the Financial Markets Strategy Team's first report in November 2007, the first half of the report was on the subprime loan problem in the United States and indicated that traceability had been a problem with the subprime loan securitized products. Likely, the problem was not with the information but with understanding it. For example, with ABS-CDO, was the 0.3 correlation coefficient assumed by the rating agency for the issues that were the underlying assets correct given that at the time of default, or did they more or less all default together? With RMBS products, statistical models using historical data were used to predict the default rate on various housing loans, but around 2005 housing loan companies started being able to make risky loans. Therefore, even if the loans were in the same grouping, they should have realized that the performance of a housing loan made in 2000 was not the same as the one made in 2005. In the United States, there is a lot of information on individual housing loans and individual issues; however, I think the information was misunderstood. That is to say, you can't enable a correct understanding of risk simply by adding information items in the unified information disclosure format. Use of the unified information disclosure format as set out in Appendix 8 of the previous meeting, in other words using it as a checklist for distributors will may lead to the collection of the decided items and mechanical analysis, which is dangerous. Evaluating the risk of securitized products requires periodic assessments in accordance with individual cases or the timeline background. To do that requires the allocation of human resources with the knowledge, experience and know-how to do so. In addition, it requires people to "think for themselves." In the case of the U.S. subprime loan problem, the underlying information was wrong, such as collateral value levels rising and falsifying the ability of debtors to assume debts. This kind of problem cannot be solved by preparing a unified information disclosure format. (In response, the WG Chair said that they would consider putting a written warning in the format to ensure the correctness of the underlying information. There is a very big difference in the design of the single level securitized products that are common in Japan and that of the multiple level securitized products that were at the heart of the subprime loan problem. It is difficult to imagine that under the present conditions the same type of problem that occurred in the securitization market in United States could happen in Japan. Furthermore, it is probably necessary to use periodic review and

other methods to manage the unified information disclosure format and prevent its value from deteriorating, and to establish routes for new skilled personnel to participate in the market, in terms of the allocation of proper human resources.)

- With CMSA as well, the investor reporting package (IRP) has been revised five times already because of changes in the items required by investors and underlying assets of the CMBS products.
- In Appendix 8 of the previous meeting there is the expression "if it is not requested by the investor." Specifically, what sort of situation should we imagine this happening in? (In reply, the WG Chair explained that for example in the case where an investor already holding a securitized product is increasing his holdings of the same product, presumably he would not request additional information.)
  In practical terms, we deliver the same information items to a lot of investors, and therefore it is not realistic to confirm and record whether or not each investor "required or did not require" information. This point should be duly considered when creating the self-regulation rules.
- Among securitized products, there are those that already have or in future will have robust secondary markets. For secondary transactions, I can understand that it is important to provide information before and at the point of sale. However, if these self-regulation rules adversely affect the forming of a secondary market, it is possible that it will be disadvantageous to both investors and originators. In particular, with private placements of securitized products, if a unified information provision is obliged in accordance with Appendix 8 of the previous meeting, the only party with enough information is the arranger, and therefore there is a concern that all other parties will be unable to trace the assets. Including this point, I think it is important to adequately consider how not to obstruct smoothly operating secondary transactions.
  Besides the effect on primary and secondary transactions, it is difficult to imagine the procedures described in Appendix 8 of the previous meeting. Taking them at surface value, it will go something like "for each securitized product there will be a list of information items, which will be checked off one by one at each time of sale." When these procedures are actually set down in writing, I would like due consideration to be given to make them easy and effective.
- In Appendix 8 of the previous meeting there was the expression "record information." Because it is obvious that information that has been provided has also been recorded, it probably is not necessary to go as far as to put it in writing in the self-regulation rules.
- Among the securitized products to which the unified information disclosure format does not apply are probably foreign securitized products. Don't we need to also consider these foreign securitized products? (The WG Chair commented that at the very least securitized products that are originated overseas with underlying foreign assets do not fall within the scope of the FSA supervision guidelines or the self-regulatory rules of JSDA at their point of origination. Therefore, individual companies would likely have to deal with the situation case-by-case using the unified information disclosure format to the extent practically possible. However, I think it would be effective for the discussions of our WG to be submitted through the FSA to international oversight authorities for use in their discussions.)
- Both the FSF report and the first report by the Financial Markets Strategy Team pointed out that the problem was U.S. securitized products, and more specifically RMBS that had securitized subprime housing loans and the ABS-CDO and CDO-Squared products that were the underlying assets of RMBS. In Japan, we do not

have the same problem with securitized products. Despite this, even though they have not caused any problems, we are enthusiastically debating on how to create rules for Japan's primary securitized products. On the other hand, the WG seems to be not going to deal with U.S. securitized products. I'm not quite comfortable with this.
- For CMBS, I think that the CMSA's IRP could be used as the base of the unified information disclosure format for conduit-type products of which there are many in the United States. In Japan, there are quite a few issues based on small numbers or single properties as well as sales & lease types, but these kinds of CMBS have extremely individualistic features, and I think it would not necessarily be suitable to use the IRP as the base for unified information disclosure format. What does everyone think of this? (In response, the WG Chair commented that with small numbers of properties there is additional information that must be provided, but basically the cash flow and other structures are the same. Therefore, he thought that it should be possible to create a unified information disclosure format using the IRP.)
- In discussions at the Japan office of CMSA as well, it was considered that unlike U.S. CMBS, there are few standardized products in Japan and one of the special features of the market is the relatively large amount of highly individualistic transactions. Therefore, this point is being taken into consideration in discussions about how to revise the U.S. IRP into a Japanese version. In other words, the investment team is saying that the area not covered by the IRP is mainly individual data on real estate, and this data needs to be additionally reflected in the IRP. Therefore the Japanese version of the IRP has a relatively higher amount of property data compared with the U.S. IRP.
- Our company cannot meet requirements to establish procedures such as those described in Appendix 8 of the previous meeting. Therefore, we would have to forgo underwriting or selling securitized products, relying only on intermediates.

The WG Chair commented that members had expressed many valid opinions, and appendices 8 and 11 of the previous meeting would be revised by taking those opinions into full consideration. Furthermore, they intended to list up the opinions that were not reflected in the revisions in the interim report, and included the following points.
- They considered that the securitized products targeted in the discussions of the WG (= products subject to the supervision guidelines) included almost all securitized products. At this point, all that had been done was to make a list of exceptions, but they intended to press forward with the discussions.
- Among the securitized products targeted in the discussions of the WG (= products subject to the supervision guidelines), there were products that the unified information disclosure format did not apply to. Starting in the fall, how should the WG deal with these products and on what is the schedule?
- The scope of the securities that were being targeted by the supervision guideline (Securities of Paragraph 1 of Financial Instruments and Exchange Act and among Paragraph 2 securities, investment trusts) and the scope of those being targeted by the self-regulatory rules of JSDA were different.
- Of the information that was among the information required by investors for details of underlying assets and risk assessment, how should the information that was not captured by the unified information disclosure format (for example, in cases where the underlying asset is a loan, whether or not a strict examination was

made based on correct information by the originator when it initiated the loan) be dealt with?
- In setting up an internal procedure on information provision, the method of handling personnel and organization is a management issue for each company and therefore it is difficult to indicate a uniform system. How can we indicate that they must attain at least a minimum capability?

It was decided to continue discussions on the internal procedure set-up for reporting information at the next meeting.

(Item 2) Internal procedures for evaluating, calculating, and reporting theoretical prices

A WG deputy Chair gave an explanation on how the WG was going to proceed with the discussion on internal procedures for evaluating, calculating, and disclosing theoretical prices using the document included as Appendix 6.

WG members made the following comments on the presentation.
- To start with, I wonder if it makes any sense to discuss the provision of market value information and theoretical prices by focusing on securitized products only and forgetting about other products. (In response, the WG Chair said that under the supervision guidelines, the items for discussion clearly included the disclosure of theoretical prices for securitized products, however at the next meeting, he would ask the FSA to comment on this point.)
- In these discussions about theoretical prices and other points regarding securitized products, I think that liquidity is one of the major points. Japan’s securitized product market has almost no liquidity, so when we are talking about theoretical prices I think it means using a specific logic to calculate a price that is far removed from a distributions price. Because the JSDA guidelines include details about not only Paragraph 1 securities but also Paragraph 2 investment trusts, I am in agreement with basing our efforts regarding the supervision guidelines on the current JSDA guidelines. However, putting aside the issue of whether or not this should be put in writing, I think it would be of benefit to us to take a specific, focused look at what theoretical prices mean in the Japanese securitization market with its current poor liquidity.
- What worries me in practical terms is that in the JSDA guidelines it says that when it is judged to be difficult for employees to make a rational assessment or calculation, the firm is to explain the reasons for that to the counterparty and not provide an assessment or calculation of market price information. However, the guideline is talking about market price and what we are considering under the supervision guidelines is theoretical price. Of course on a conceptual level there is a difference between market price and theoretical price, but on the other hand the responses to the public comment paper by the FSA indicate that theoretical price should be treated in the same way as in the JSDA guidelines. In practice, compared with market price, theoretical price is more likely to be difficult to assess or calculate. Perhaps the WG should clarify how the treatment of market price under the JSDA guidelines is equivalent to a treatment of theoretical price?

A WG deputy Chair commented that he felt that rather than theoretical price, the emphasis of the supervision guidelines was probably on avoiding arbitrary

calculations. In this WG we need to carefully consider how do deal with the concept of theoretical pricing and with liquidity risk.

WG members made the following comments

- In our company's case, many of the securitized products being sold were originated overseas. In this situation, providing theoretical prices "quickly and accurately" as the supervision guidelines say would be difficult. Furthermore, if a theoretical price was provided, then there is a possibility that it would take on a life of its own. I would like this point to be kept in mind if we are going to put something on theoretical prices into the self-regulation or other rules.

In reply, the WG Chair commented that he would like to include in the interim report an indication that there was a difficult problem with providing theoretical prices when it came to securitized products originated overseas.

(End of document)